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No. 93-271

In the Supreme Court of the United States

OCTOBER TERM, 1993

MADISON LIBRARY, INC., ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether, in upholding the jury's finding that petitioners made gross valuation overstatements within the meaning of 26 U.S.C. 6700 in connection with their promotion of a tax shelter, the court of appeals erred in holding (i) that the purchase price paid for the property by the principal promoter of the tax shelter was not conclusive as to the fair market value of the property and (ii) that the district court did not abuse its discretion in admitting appraisal evidence to establish the fair market value of the property.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	2
Argument	9
Conclusion	13

TABLE OF AUTHORITIES

Cases:

Abramson v. *Commissioner*, 86 T.C. 360 (1986)	11
Bixby v. *Commissioner*, 58 T.C. 757 (1972)	7, 9, 11
Bryant v. *Commissioner*, 790 F.2d 1463 (9th Cir. 1986)	9
Cornfeld v. *Commissioner*, 797 F.2d 1049 (D.C. Cir. 1986)	12
Frank Lyon Co. v. *United States*, 435 U.S. 561 (1978)	10
King v. *United States*, 545 F.2d 700 (10th Cir. 1976)	12
Sheid v. *Commissioner*, 50 T.C.M. (CCH) 663 (1985)	11
Simon v. *New Haven Board & Carton Co.*, 393 F. Supp. 139 (D. Conn. 1974), aff'd, 516 F.2d 303 (2d Cir. 1975)	12
Tiffany Fine Arts, Inc. v. *United States*, 469 U.S. 310 (1985)	12-13
United States v. *Cartwright*, 411 U.S. 546 (1973)	9

Statutes:

Internal Revenue Code (26 U.S.C.):	
§ 38	3
§ 46(a)	3
§ 48(d)	3
§ 6700	2, 4, 5, 6, 7, 9, 10
§ 6700(a) (1982)	4
§ 6700(a)	4
§ 6700(b)(1)(A)	4
§ 6703	5
Tax Reform Act of 1986, Pub. L. No. 99-514, § 211(a), 100 Stat. 2166	3

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A26) is reported at 989 F.2d 1290. The opinion of the district court is reported at 766 F. Supp. 1248.

JURISDICTION

The judgment of the court of appeals was entered on March 22, 1993. The petition for rehearing was denied on May 20, 1993 (Pet. App. A29). The petition for a writ of certiorari was filed on August 17, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. This case involves the imposition of a penalty under Section 6700 of the Internal Revenue Code for the promotion of an abusive tax shelter. The tax shelter involved the purchase and subsequent leasing of rights to market books and computer software. Those rights, together with the metallic plates, lithographic films, and other equipment used in printing the books and reproducing the software, are referred to as the "properties" (Pet. App. A6). Petitioners Geoffrey Townsend, Ltd. (Townsend) and Universal Publishing Resources, Ltd. (Universal), both of which were wholly owned subsidiaries of petitioner Madison Library, Inc., purchased the properties from publishing companies during 1982 and 1983 (*id.* at A5-A6). Irving Cohen, who was president of Townsend, Universal and Madison Library, negotiated the purchases on behalf of the corporations (*ibid.*).[1]

The properties were all purchased under the same format. Townsend and Universal made small cash down payments and executed promissory notes bearing interest at nine percent for the remainder of the purchase prices (Pet. App. A6). Except to the extent that net revenues were realized from retail sales of the books or software, no payments of principal or interest on the notes were due for 12 years. At the end of the twelfth year, Townsend and Universal were obligated to make balloon payments of the remaining unpaid interest and principal (*ibid.*).

The linchpin of petitioners' scheme was establishing highly inflated purchase prices for the properties in order to maximize the hoped-for tax benefits. The purchase prices were determined for each property by mul-

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[1] The stock of Madison Library, Inc., was held in trust for the benefit of the children of Irving Cohen (Pet. App. A5).

tiplying the projected number of copies of the books or computer programs to be produced by a percentage of the expected retail sales price of those items (Pet. App. A6). Applying this formula, Townsend and Universal purchased 3774 properties during 1982 and 1983 at an average price that exceeded $500,000 per property, thereby ostensibly incurring a combined total debt that exceeded $1.9 billion (*id.* at A7).

2. Townsend and Universal leased interests in the properties to 95 limited partnerships. Petitioner Barrister Associates, a New York general partnership in which petitioners Robert Gold and Paul Belloff were the sole partners, was the general partner for each of the 95 limited partnerships (Pet. App. A5, A7). Under the lease agreements, Townsend and Universal agreed to pass through to the limited partnerships investment tax credits of from eight to ten percent of the fair market value of each property (*id.* at A7-A8). See 26 U.S.C. 38, 46(a), 48(d).[2]

Interests in the limited partnerships were marketed to the public by petitioner Chadwick Investment Co., a Subchapter S corporation owned by Gold, Belloff and an unrelated party (Pet. App. A5, A9). Petitioners represented that the fair market value of each property was equal to the purchase price Townsend and Universal had negotiated. A brochure used to market one of the limited partnerships explained that a limited partner in the 50% tax bracket who invested $50,000 would obtain investment tax credits and income tax deductions that would generate tax savings of $75,600 (*id.* at A8).

None of the limited partnerships printed, manufactured, or distributed the books or software. Entities

[2] The investment tax credit was generally repealed for property placed in service after December 31, 1985. Tax Reform Act of 1986, Pub. L. No. 99-514, § 211(a), 100 Stat. 2166.

known as "service contractors" were retained to perform those tasks and to bear the related costs (Pet. App. A8). The service contractors were ordinarily affiliated with the publisher who had sold the property to petitioners (*ibid.*). In return for their services, the contractors collected fees from the limited partnerships based on a percentage of the sales price of each book or software item actually sold (*id.* at A9).[3] Under the terms of the purchase and service agreements, virtually all net revenues to be realized from sales flowed to the publishers, either directly or through payments to the service contractors (*id.* at A16).

3. Section 6700 of the Code imposes a penalty on persons who engage in the promotion of abusive tax shelters. The penalty applies to "[a]ny person" who "organizes (or assists in the organization of)" a partnership or other entity (i) that makes statements with respect to the allowability of tax benefits that the person knows or has reason to know are false or fraudulent or (ii) that makes "a gross valuation overstatement as to any material matter" (26 U.S.C. 6700(a)). The term "gross valuation overstatement" is defined to mean an overstatement in the value of a property that "exceeds 200 percent of the amount determined to be the correct valuation" (26 U.S.C. 6700(b)(1)(A)). The amount of the penalty at the time of petitioners' activities was the greater of $1,000 or 10 percent of the gross income derived (or to be derived) by such person from such activity. See 26 U.S.C. 6700(a) (1982); Pet. App. A12-A13, A17.

[3] The service agreements specified an anticipated initial printing, and minimum additional printings, that established the maximum number of copies the service contractor was required to print. Although the service agreements were negotiated by the same parties who negotiated the prices of the properties, the number of copies in these agreements bore no relation to the number of copies used in determining the properties' prices (Pet. App. A9).

The Internal Revenue Service determined that petitioners made false and fraudulent statements and gross valuation overstatements subject to penalty under Section 6700. Petitioners paid a portion of the penalties assessed against them and instituted suits for refund of the amounts paid. See 26 U.S.C. 6703. The government filed counterclaims for the unpaid balance of the penalties (Pet. App. A9-A10).

4. The issue of liability for the penalties was tried to a jury. Six of the limited partnerships were chosen by the parties as representative of all of the partnerships for purposes of the trial (Pet. App. A11). The evidence admitted at trial included documentary evidence establishing the nature and details of the various transactions for each property and appraisal reports and testimony offered by both petitioners and respondent. The district court rejected petitioners' contention that the appraisal evidence offered by the government was too subjective to be relevant and admissible (*id.* at A16-A17). The government's appraisal witnesses valued the properties at approximately 2.5% of the prices to which Townsend and Universal had agreed.[4]

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[4] The total fair market value of the properties claimed by petitioners for the purpose of computing the investment tax credits was $143,691,000. The government's appraisal witnesses testified that the fair market value of those properties was $3,612,648 (C.A. App. 923-934). Petitioners' appraisal witness did not independently appraise the properties. Instead, he testified that the prices paid for the properties could have been arrived at by the parties by negotiation (*id.* at 1905).

The government also presented expert financial analyses and testimony concerning the profit potential of the books in question based on (i) the actual sales experience from 28 limited partnerships involved in a related program (C.A. App. 1812-1819); (ii) industry average sales (*id.* at 1819-1826, 1834-1835); and (iii) the assumption that one book in each partnership would achieve sales equal to those of the very best selling book in the industry in the

The district court instructed the jury that the fair market value of a property was "the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts" (C.A. App. 79). The court further instructed the jury to accord expert opinion "such weight as you may think it deserves," noting that, if the opinion was not based upon "sufficient facts, or if you should conclude that the reasons given in support of the opinion are not sound, you may reject the opinion entirely" (*id.* at 73). The court also instructed the jury that, "[u]nless the [government] has established that Universal and Townsend consciously inflated the purchase prices of the properties under the terms of their acquisition agreements, you should find that the purchase price they negotiated is [the] fair market value of the book properties" (*id.* at 81). The jury was further instructed that the value must be determined based on the facts known at the time the transactions occurred, and that "Monday morning quarterbacking has no place in this valuation process" (*ibid.*).

The jury returned a verdict finding that petitioners "did not purchase the properties in the six test partnerships in good faith, bona fide arm's length transactions" and had made gross valuation overstatements within the meaning of Section 6700 (C.A. App. 175-176). The jury found a total of 17 false or fraudulent statements that

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previous year (*id.* at 1829-1830). Those analyses showed that the stated purchase prices of the properties were grossly in excess of the amounts that could be realized from sales. There was also evidence that books comparable to those for which Townsend and Universal negotiated six- to seven-figure prices often could have been produced on a for-hire basis for a few thousand dollars (*id.* at 1303, 1306-1307, 1312, 1315, 1322, 1327, 1932-1937, 1941-1942, 1944-1946).

were subject to penalty under the statute (*id.* at 134-192). Petitioners filed motions for judgments notwithstanding the verdicts or for new trials, which the district court denied (Pet. App. A33).[5]

5. The court of appeals upheld the jury's finding that petitioners had made gross valuation overstatements and affirmed the judgment of liability under Section 6700. The court stated that, although a price arrived at through arm's length negotiations is "usually the most reliable evidence of fair market value," that price is not conclusive when, for example, "a transaction is based upon 'peculiar circumstances' which influence the purchaser to agree to a price in excess of the property's fair market value" (Pet. App. A14, quoting *Bixby* v. *Commissioner*, 58 T.C. 757, 776 (1972)). The court concluded that the government's appraisal evidence was not inadmissible simply because there was also evidence of arm's length bargaining in this case: evidence of the negotiated prices and the expert appraisal evidence were both relevant in determining the properties' values (Pet. App. A14-A15).

Reviewing "the totality of the evidence offered by the government, including the testimony and reports of the appraisers and the evidence concerning the various relationships and transactions" (Pet. App. A15), the court noted that there was a substantial basis for the jury to find that petitioners' transactions were not at arm's length. The evidence reflected that petitioners' transactions "were based on the sort of 'peculiar circumstances' that defeat any presumption that the purchase prices re-

[5] Pursuant to an agreement of the parties, the amount of the penalties was determined by the district court, rather than by the jury. The government filed a cross-appeal on two computational issues resolved by the district court (Pet. App. A12, A24-A26). Neither of the computational issues is involved at this stage of the case.

flected the fair market values of each of the Properties" (*id.* at A16). The "facts concerning this tax shelter, and inferences to be drawn from them," indicated that petitioners "had strong incentives to agree to inflated prices in order to increase the tax benefits available to the limited partnerships" (*id.* at A15). Moreover, the excessive prices did not create "genuine risk of loss beyond the downpayments" because the publishers could look only to the corporate assets of Townsend and Universal at the end of the twelve-year term for collection, and could "easily find that by then the corporate cupboards would be bare" (*ibid.*). "Once the transactions were so understood by the jury," the court held, "its conclusion that [Townsend and Universal] wanted to inflate the size of the promissory obligations—the larger the obligation, the greater the resulting investment tax credit—was inexorable" (*id.* at A16).

The court also rejected petitioners' contention that the government's appraisal evidence was "too subjective to be admissible" (Pet. App. A16). The government's appraisers were "qualified as experts," and "their valuations were grounded on their experience in the publishing industry and on objective factors such as the potential market for the book or software, the reputation of the author, and competition from other works" (*id.* at A16-A17).

In view of its decision that petitioners had made gross valuation overstatements, the court found it unnecessary to review the jury's further findings that petitioners had made false and fraudulent statements (Pet. App. A13).[6]

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[6] The court of appeals held in favor of the government on one of the two computational issues raised by the government in its cross-appeal. See note 5, *supra*.

ARGUMENT

The jury had an ample evidentiary basis to find that petitioners made gross valuation overstatements within the meaning of Section 6700 of the Internal Revenue Code. The decision of the court of appeals does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. The fair market value of a property is generally defined as the price at which it would change hands between a willing buyer and a willing seller, neither being under compulsion to buy or sell, and both having reasonable knowledge of the relevant facts. *United States* v. *Cartwright*, 411 U.S. 546, 551 (1973). Although a price reached in arm's length negotiations between a buyer and seller is often reliable evidence of fair market value, the agreed price is not necessarily conclusive of the correct fair market value. This is especially so when special circumstances may have influenced the purchaser to agree to an excessive price. *Bryant* v. *Commissioner*, 790 F.2d 1463, 1465-1466 (9th Cir. 1986); *Bixby* v. *Commissioner*, 58 T.C. 757, 776 (1972).

In the present case, the jury was entitled to find that, in negotiating the prices of the properties on behalf of Townsend and Universal, Irving Cohen consciously agreed to grossly excessive prices (largely on long-term credit) in the hope of generating artificially large investment tax credits. By agreeing to prices far in excess of the fair market value of the properties, the partners of the limited partnerships that leased the properties hoped to realize inflated tax credits and deductions that would yield tax benefits in excess of their investments even if no books or computer programs were ever sold. The average price of each property exceeded $500,000, a price that assumed enormous sales volumes. The government's appraisal evidence showed that the agreed prices were approximately 40 times greater than

the properties' fair market values. There was also evidence, in many instances, that properties comparable to those purchased by petitioners for six- to seven-figure prices could have been produced on a for-hire basis in the marketplace for a few thousand dollars. See note 4, *supra*. Moreover, since the publishers could look for payment only to the assets (if any) that might remain in Townsend and Universal at the end of the twelve-year terms of the notes, the jury could properly conclude that there was never an intention that the inflated purchase prices would actually be paid (Pet. App. A15). Based on the totality of this evidence, the court of appeals correctly upheld the jury's finding that Townsend and Universal did not purchase the properties in bona fide arm's length transactions and that, in representing that the fair market values of the properties were equal to the prices Universal and Townsend ostensibly agreed to pay, petitioners made gross valuation overstatements within the meaning of Section 6700.

2. Petitioners erroneously assert that the court of appeals held that mere "consideration of tax consequences is sufficient grounds to disregard a negotiated purchase price and to overcome uncontradicted testimony that the bargaining was at arm's length" (Pet. 12). Based on that erroneous assertion, petitioners contend that the decision in this case conflicts with decisions of this and other courts. *E.g.*, *Frank Lyon Co.* v. *United States*, 435 U.S. 561, 580 (1978).

Petitioners' characterization of the court's decision is not correct. The court of appeals held that the jury was entitled to find that Townsend and Universal wanted to inflate the size of the promissory obligation because "the larger the obligation, the greater the resulting investment tax credit" (Pet. App. A16). Petitioners did not merely take potential tax benefits into account in purchasing the properties. They sought to create bogus in-

vestment tax credits by deliberately agreeing to grossly inflated purchase prices that were payable only out of any assets that might remain in Townsend and Universal 12 years later. The decision of the court of appeals simply reflects that when, as in the present case, there are "peculiar circumstances" that may "influence the purchaser to agree to a price in excess of the property's fair market value," the price that the parties negotiate is not necessarily conclusive of the fair market value of the property (*id.* at A14, quoting *Bixby* v. *Commissioner*, 58 T.C. at 776).

3. Petitioners further contend (Pet. 15) that the decision in this case conflicts with the decisions of the Tax Court in *Sheid* v. *Commissioner*, 50 T.C.M. (CCH) 663, 670 n.24 (1985), and *Abramson* v. *Commissioner*, 86 T.C. 360, 372 & n.16 (1986). Petitioners assert that the Tax Court held in those cases that appraisal evidence is not admissible unless there has been an independent demonstration that there was an absence of arm's length bargaining. In *Sheid*, however, the Tax Court held simply that it was "open to question" whether appraisal evidence was relevant where there were "no *special circumstances* present" (50 T.C.M. (CCH) at 670 (emphasis added)). In *Abramson*, the Tax Court similarly concluded that, "there being no *special circumstances* present," it was "open to question whether appraisal testimony has any relevance" (86 T.C. at 372 (emphasis added)). Neither case involved the question whether appraisal evidence is admissible when the purchaser deliberately agreed to a price in excess of the property's fair market value.[7]

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[7] In a similar vein, petitioners assert (Pet. 13-14) that the decision in this case conflicts with decisions in which courts have disapproved of the use of hindsight or the second guessing of a taxpayer's business judgments in determining whether the taxpayer had a genuine profit motive. Petitioners cite (Pet. 13) as an exam-

4. There is no merit to petitioners' assertions that the decision of the court of appeals conflicts with decisions in which the courts have disapproved of purely subjective expert testimony (Pet. 17-19). The district court did not credit petitioners' assertions that the government's appraisal evidence was too subjective to be admissible; and, as the court of appeals observed, "[t]he four government appraisers were qualified as experts, and their valuations were grounded on their experience in the publishing industry and on objective factors such as the potential market for the book or software, the reputation of the author, and competition from other works" (Pet. App. A16-A17). Petitioners' assertion that the appraisal evidence was too subjective to be admitted was thus properly rejected by both courts below. Further review of this factual claim is not warranted. See *Tiffany*

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ple *Cornfeld* v. *Commissioner*, 797 F.2d 1049 (D.C. Cir. 1986), which presented the question whether a taxpayer engaged in an activity (the leasing of aircraft) with the requisite profit motive that would permit him to deduct expenses associated with the activity. In neither *Cornfeld* nor any other case cited by petitioners did the courts hold that appraisal evidence may not be used to show the fair market value of property or that appraisal evidence is not admissible in a case in which the purchaser of property is claimed to have agreed to excessive prices in order to artificially inflate the amount of the investment tax credit to be claimed for the property.

Petitioners also suggest (Pet. 15-16), by quotations from *King* v. *United States*, 545 F.2d 700, 709 (10th Cir. 1976), and *Simon* v. *New Haven Board & Carton Co.*, 393 F. Supp. 139, 145 (D. Conn. 1974), aff'd, 516 F.2d 303 (2d Cir. 1975), that the jury and the court of appeals improperly took into account the actual profitability (or lack thereof) of the properties after their acquisition in determining their fair market value. But evidence of the actual profitability of the properties after their acquisition was excluded at trial and was not considered by the jury or by the court of appeals. See page 6, *supra*.

Fine Arts, Inc. v. *United States*, 469 U.S. 310, 318 n.5 (1985).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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